Ontario

Commission of Inquiry
into
Residential Tenancies

The Political Economy of Residential Rent Control in Ontario

D. G. Hartle

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perspective of conventional economics unless its presumably unintended allocative effects fortuitously offset existing imperfections in the rental housing market -- imperfections that may be inherent, "man-made" by governments, or both. Given the number of ways in which government has intervened in the housing market, for example, zoning restrictions, building codes, non-taxation of the imputed rents or owner-occupied housing, and subsidies for low-income tenants), the possibility of such a fortuitous result cannot be dismissed out of hand.

Rent control -- government intervention by regulation -- has the same economic consequences as the imposition of a tax and the simultaneous provision of a subsidy. In this case, the benefits are extracted from some landlords and transferred directly and immediately to some tenants. Both the tax and the subsidy distort the allocation of resources and thereby impose economic costs. This is the effect of all taxes and subsidies that are anticipated. The narrower is the tax and subsidy base and the greater are the opportunities for avoiding the tax or for qualifying for the subsidy, the greater are the efficiency costs. Therefore taxes and subsidies related to a broad base, such as income, provide an approach to redistribution that is less costly than rent control. However, even broad-based taxes and subsidies distort the choice between work and leisure.

Recent work has emphasized "transaction costs", a set of costs that was largely ignored in the past. In the past, economists seldom looked beyond the allocative effects of

redistribution as I have outlined them here. Recent work has stressed two other factors: the transactions costs associated with redistribution and the political processes that give rise to measures with redistribution effects, actual or presumed. The theoretical bases of these new researches - the theory of rent seeking and the theory of public choice - do not depart from the essential premises of neo-classical economics: rather they extend those premises into wider realms. A major purpose of this study will be to explain the fundamental implications of rent seeking theory and public choice theory for rent control as it is practised in Ontario. Transaction costs are the costs of bargaining, contracting, and contract enforcement. Sometimes the information costs specific to a contract are also counted as transaction costs. Some voluntary exchanges do not take place simply because the costs of negotiating and enforcing the terms of exchange are too great relative to the gross benefit to be obtained. There would be no net benefit. By the same token, when taxes and subsidies are put in place, the competition for the "rent" -- the non-exclusively assigned value of the benefit -- will require an expenditure of real resources. In other words, when the ownership of a right to a benefit is not clearly and exclusively assigned, contenders for the benefit will invest resources in the effort to obtain a share of it. This behaviour is called "rent seeking". In extreme circumstances, the resources wasted in rent seeking will equal or exceed the value of the

benefit sought. The non-exclusive rights (benefits) are "dissipated" or "wasted". Thus, the economic costs of redistribution that arise from rent seeking can, in the extreme, be much higher than the costs that arise from the changes in relative prices brought about by the taxes and subsidies introduced under the redistribution policy. It should be noted that in this context the term "rent" obviously has little to do with the term in common usage.

Given that redistribution is inevitably costly in economic welfare terms and particularly costly when attempted on narrow bases, economists formerly tended to reject measures such as rent control out of hand. Many still do. What has recently emerged, at least for those persuaded by the theory of public choice, is a better understanding of the <u>political</u> dimensions of the redistribution issue, where the term "political" has no pejorative connotations. If we apply the assumption of self-interest to the behaviour of politicians, bureaucrats, lobby groups, and journalists, and incorporate the insight that organizational structures and procedures create an implicit set of relative prices that affect the rates of exchange of political as well as economic benefits, much non-economic behaviour becomes explicable in terms of economic concepts. The competition for votes by politicians and political parties, and the attempts by pressure groups to obtain advantages or to remove impediments to their interests, all within an environment where unbiased information is scarce and hence costly, explain many policy decisions. One may not like

what policy-makers decide, but -- as I shall attempt to demonstrate in this paper -- the public choice perspective makes the reasons for their decisions relatively clear.

The paper consists of eight sections. The first three provide some necessary background. The first considers the circumstances that prevailed when a system of rent control was introduced in Ontario in 1975. The second discusses the basic provisions of that system; it includes a brief summary of the system's economic attributes and the conventional analysis of its effects. The third section expands upon the very brief exposition of traditional welfare economics given in this introduction.

As I have said, the theory of rent seeking purports to explain the circumstances under which transaction costs waste resources when governments intervene in attempts to transfer benefits between individuals. The theory, particularly as it relates to residential rent control, is considered in the fourth section.

The cupboard is painfully bare when we come to it for estimates of the actual transaction costs entailed by Ontario's current rent control system -- the costs that the theory of rent seeking emphasizes. I have used some horrendous assumptions and the few pieces of "hard" information at hand to arrive at the crude estimates of these costs given in the fifth section. While these estimates are obviously weak, they provide, perhaps, some insight into the orders of magnitude involved. The assumptions are clearly

spelled out, so readers can readily substitute their own guesses if they like.

The public choice approach to the processes of collective decision-making is described in the sixth section, where the roles and incentives of self-seeking politicians, bureaucrats, pressure groups, and journalists are related to the self-seeking behaviour of largely ill-informed voters. Some find repugnant the basic assumption of ubiquitous self-seeking, but this sense of outrage is misplaced. We make assumptions in order to analyse reality, not in order to describe it. Simplification is the essence of conceptual insight.

Conventional economics and public choice economics share the same conceptual underpinnings, yet they seem to diverge markedly in their implications. The seventh section considers how these two approaches may be reconciled. In more than one interpretation, the keys to reconciliation are the competition among political parties for votes and voters' awareness of the relative efficiency of the existing or promised policies of the parties. Poor policies are driven out by better policies because the latter attract votes while the former do not. However, given that each party confronts voters not with a single policy but with a bundle of policies, good, bad, and indifferent, the assumption that voters know which alternatives are the most efficient is questionable.

The final section briefly sets forth some possible implications of the previous discussion.

THE EMERGENCE OF RENT CONTROL

An English judge who changed his mind defended himself in the following terms: "It does not appear to me now as it appears to have appeared to me then." And so it is with governments. When voter perceptions change in response to a real or an illusory change in circumstances, an "unthinkable" policy option can become not only "possible" but, finally, "inevitable". The Ontario government's stand on residential rent control illustrates the point admirably.

Until the campaign preceding the election of September 18, 1975, which returned the Progressive Conservatives with a minority, the government of Premier William Davis consistently and strongly opposed rent control.[1] Two weeks before the election --, on September 3, to be exact -- the Davis government announced its intention to introduce a system of what is somewhat euphemistically called "rent review". This system was to operate only in low-vacancy areas. Rent review boards would not be empowered to suspend rent increases unless exemplary prosecutions undertaken by the province on the advice of the boards failed.

The factors that brought about the change in the Davis government's stance can probably never be fully known. No doubt the private polls commissioned by the party in power indicated a shift in voter attitudes. This shift presumably reflected both the deterioration of the economy -- higher unemployment and higher prices generally -- and the publicity given to some large rent increases. The

Provincial New Democratic Party had been pressing for rent control since the 1960's, consequently NDP leader Stephen Lewis' announcement of August 17, 1975, that housing was the first of his party's four platform themes must have come as little surprise to the government. Probably more decisive was then Liberal leader Robert Nixon's announcement on August 25 that the party platform included a promise to establish rent review boards with the power to "roll back rents".

On September 8, only ten days before the election, Davis announced that the Ontario GAINS (Guaranteed Income Supplement) would be used to cushion, for low-income tenants, the impact of rent increases in excess of 12 per cent. He reiterated the stand that the publicity attendant upon prosecutions for excessive rent increases would be a sufficient deterrent -- a position that was ridiculed by Stephen Lewis. On September 13 the government promised to protect tenant rights and to pay tenants' legal costs. On the same day Lewis claimed that rent control was "a lasting answer to the housing shortage".

Thus it seems clear that only a sense of political exigency induced the Conservatives to abandon their earlier stance. They gave up as little as possible. The government seems to have believed that the rent control issue carried weight with so many crucially situated voters that it had to <u>appear</u> to be going about as far as the Liberals. Whether or not a more far-reaching rent control scheme would have

returned the Davis government with a majority rather than a minority is moot. Only days after the election, however, Davis and Co. decided that the selective prosecutions procedure had to be rejected in favour of means that would be acceptable to the opposition parties (Bucknall 1976). The result was an announcement in the Speech from the Throne on October 29 that the government would introduce both retroactive measures to protect tenants from unjustified rent increases and measures designed to strengthen tenants' security of tenure. Thus the "new" Davis government announced that it would do precisely what the "old" Davis government had only recently stated it would never do.

Policy reversals, although not uncommon, are customarily greeted with derision by political observers, who take them as evidence of cynical opportunism or worse. It is equally plausible to view policy about-turns as evidence of the effectiveness of the interparty competition for voter support -- the foundation of responsible and representative government in the face of changing circumstances and perceptions.

The most obvious reason for the Conservatives' change of position was their need to secure the acquiescence of one or both of the opposition parties if they were to continue to form the government. Another reason, which the Conservatives may have accepted as legitimate in its own right and which certainly helped to legitimize the policy reversal, was Prime Minister Pierre Trudeau's televised announcement on October 13, 1975 of the federal government's

anti-inflation initiatives. Here too a government reversed itself, for during the campaign that preceded the election of July 1974 the federal Liberals had declared themselves opposed to wage and price controls -- unlike the federal NDP and the federal Conservatives.

To understand these major policy changes at both the federal and the provincial levels, it is necessary to recall the economic situation at the time. Although conditions subsequently became a great deal worse, 1975 saw the arrival in Canada of double-digit inflation (+10.2 per cent). It also witnessed a substantial increase in the unemployment rate, which in Ontario rose from 4.4 per cent in 1974 to 6.3 per cent in 1975. Hitherto, it had been widely believed that there was a clear trade-off between the inflation rate and the unemployment rate. An improvement in one rate could be "bought" by accepting a deterioration in the other. Now, however, the old Keynesian remedies appeared to have lost their efficacy -- if they had ever had any. To confuse the picture, the massive "reforms" of the Unemployment Insurance benefit structure in the early 1970's had encouraged people to work just long enough to obtain extraordinarily long periods of benefits -- benefits that were only a little below the income that could have been earned by working. This raised questions about the legitimacy of the unemployment data (an old issue) and about the structural problems of the Canadian economy. One thing is certain about 1975: it was a year of great uncertainty after decades of

seemingly endless prosperity. As it turned out, the voters had much to be concerned about.

Quite apart from this general economic malaise, there were specific events in the rental housing market in the early 1970's that may well explain why rent increases were singled out for attack. Construction is a highly cyclical industry. Following a period of glut, vacancy rates gradually fall, rents rise more rapidly, and a faster pace of construction heralds the beginning of a new cycle. When this addition to the stock comes on the market, considerably later, vacancy rates rise again, the rate of rent increase declines, and new construction drops off. Still later, when population and income growth have taken up the slack, the cycle repeats itself. The cycle is therefore largely a result of the industry's failure to adequately anticipate future changes in demand and of its delayed overreaction to these changes.

In any event, the rate of increase in rents fell from about 1967 until about 1972 and new construction was deterred. In the following three years the trend reversed and rents increased more rapidly -- presumably more rapidly than anticipated by the industry. From 1974 to 1975 the CPI rose by 10.8 per cent. Smith and Tomlinson (1981, 96) estimate that the rent (exclusive of financing costs) for a one-bedroom apartment in Toronto rose 31 per cent in current dollars (from $99 to $130). There was, therefore, some basis for tenant concern. Whether the measures adopted were "necessary" or "effective" is another matter.

THE MAIN FEATURES OF THE CURRENT SYSTEM

A moderate form of rent control has existed in Ontario since the passage on November 20, 1975 of the Act to Provide for the Review of Rents in Respect of Residential Premises. The Act originally provided for its own repeal on August 1, 1977. Subsequent amendments extended it. The Residential Tenancies Act of 1979, which replaced the Rent Review Act, has effect for an indefinite period. From the retroactive application of this legislation in July 1975 until October 1977, rents on non-excluded residential properties could be increased only once a year and the increase could not exceed the annual increase in the landlord's costs. The maximum increase permitted without special approval, and barring tenant objections, was 8 per cent a year. From October 1977 to the present, the maximum increase allowed without approval and in the absence of tenant objection, which would trigger a hearing, has been 6 per cent. Landlords must give their tenants ninety days prior notice of any intended increase. Landlords who apply for permission to increase rents by more than the ceiling must demonstrate at a hearing that a larger increase is necessary to fully cover the increase in allowable costs. When the increase is below the ceiling, tenants can still require that a hearing be held. Under certain extremely limited circumstances (defined in section 132 of the Residential Tenancies Act), rents can be rolled back.

Rent control does not apply to non-profit housing, government-assisted housing, units in a building no part of which was rented before January 1, 1976 (including newly constructed rental units), or so-called "luxury" units with rents in excess of $750 per month. Because rent control in Ontario embodies a qualified "cost pass-through" arrangement, and because it excludes some rental accommodation, it would seem to merit the adjective "moderate" used earlier, although the restrictive definition of allowable costs moderates the degree of moderation.

The legislation makes an important distinction between "whole building reviews" and reviews that apply to 15 per cent or less of the units in a building in a given year. In the latter case -- rent reviews undertaken on behalf of a tenant -- the landlord's costs are not taken into account. In the former case, the only one considered here, allowable costs for pass-through purposes are treated somewhat differently when there is a "financial loss" than they are when there is not a financial loss. Where no financial loss (as defined by the rent review procedure) exists, allowable costs are determined so as to, in effect, "freeze" net rents at their pre-control level for the two-year period being reviewed and prevent landlords from obtaining direct benefits from capital expenditures and planned quality deterioration. To this end, costs that may be passed through on a year-to-year basis are limited to operating costs and financing costs that refer directly to the dwelling under review. Maintenance and repair costs are

narrowly defined. Cost increases arising from a capital expenditure are allowed only at a rate sufficient to amortize the expenditure over the expected future life at a rate of interest on borrowed funds equal to the prime first mortgage rate. Given these and other deviations from either accounting or economic costs, the term "freeze" is more an expression of conventional wisdom than of fact.

When a "financial loss" occurs, the landlord may apply for an increase that will eliminate the loss over a three-year period (five years if the loss arises from the purchase of a building). Before 1982, allowable costs included all operating costs and financing costs (interest and principal) for financing not in excess of 85 per cent of acquisition costs. Neither depreciation nor a return on equity capital were allowed, but normal principal payments were considered a cost. As originally established, these provisions meant that landlords just broke even on a cash-flow basis. A "relief of hardship" provision was introduced in 1979 to allow an additional rent increase of 2 per cent of total cost.

In 1982, Cadillac Fairview sold a large number of rental units. They were quickly resold several times at ever-higher prices, a procedure that greatly increased financing costs and hence allowable rent increases. The ensuing controversy led the Government of Ontario to introduce a bill that was passed as <u>An Act to Provide for an Interim Restraint on the Pass Through of Financial Costs in</u>

Respect of Residential Finances. This measure put a ceiling of 5 per cent on rent increases attributable to increased financing costs.

Given the Davis government's evident reluctance to adopt rent controls in the first place, why did it not leave this loophole open when it was exploited in 1982? There is no obvious answer to this question. Perhaps because the exploitation was so blatant, and therefore attracted disconcerting press (and opposition party) attention, "corrective" action could not be avoided. Perhaps the officials responsible for rent review ingenuously took their task at face value. Perhaps too, the Conservatives' earlier, presumably ideological, objections to controls evaporated in the face of perceived political realities.

It will be argued later, at considerable length, that the introduction of rent controls gives affected landlords an inducement to minimize any losses (relative to an uncontrolled market situation) they entail. For their part, tenants with rent-controlled accommodation have an inducement to fight in order to retain or increase their benefits. There is legislation other than the rent control legislation as such that constrains the actions of those who would otherwise escape some or all of the controls' effects. These related legislative or regulatory measures also need to be taken into account.

Roughly speaking, the market value of rental accommodation is equal to the present value of its expected net income, where the applicable discount rate reflects going

interest rates, the risks attached to the particular investment, and the income tax position of the investor. The more restrictive are rent controls, the greater is the capital loss and the greater is the incentive to convert the existing building to single-owner occupancy or condominium ownership or to demolish the building and construct the highest allowable density of new condominiums or rental units not subject to regulation. To block these moves, and thereby maintain the supply of rent-controlled accommodation (ignoring quality renovations), many municipalities in Ontario, and all of the municipalities in Metro Toronto, have passed bylaws that restrict demolitions, conversions, or both (see Smith and Tomlinson 1981, 110).

Tenants would gain little from rent controls if landlords could easily evict them and either charge new tenants higher rents in one form or another or replace them with "superior" tenants. Since the inception of Ontario's rent control system in 1975, the Landlord and Tenant Act has successfully blocked such actions by giving tenants great security of tenure. Evictions are possible only under quite extraordinary circumstances that are costly to prove before a tribunal. The same statute restricts the size of deposits to one final month's rent in advance. Landlords are required to pay 6 per cent interest on such deposits.

The conventional economic analysis of rent review in Ontario is a large topic. Because it has been dealt with elsewhere,[2] a brief synopsis will do for present purposes.

Following Smith and Tomlinson (1981), whose deductive analysis (as distinct from their quantitative estimates) seems to be unquestioned, we can assume that the Ontario rental market under rent control has, or has had, the following attributes:

1. The demand for residential accommodation increased rapidly in the years preceding the introduction of rent controls. The factors in this increase were the maturing of "baby boom" children, increases (partly real and partly inflationary) in personal income, continued urbanization, a growth in the number of single-member households, and immigration.

2. Because housing supply responds only slowly to changes in demand, rents started to move up sharply.

3. Controlled rents were initially set at prevailing market rents. In the first instance controlled accommodation was held by those who were its tenants when controls came into effect.

4. Controlled rents were soon less than the market-clearing rents would have been: there was, therefore, excess demand at prevailing prices.

5. New units have not been subject to rent control. Additional rental units have been built, but landlords

require a premium rent for these units to compensate for the risk that the controls will later be extended to them.

6. Owners of rent-controlled accommodation sustained a potential capital loss when controls were implemented. They sought and still seek to minimize this loss through one or more of the following stratagems:

(a) Conversion to uncontrolled uses (condominiums, luxury apartments, and non-residential uses).

(b) Reduced maintenance, whereby quality deterioration lowers the controlled rent to the point where it equals the rent that could be obtained in an uncontrolled market.

(c) When vacancies occur, landlords select the "best" tenants available. Their criteria include financial solvency and reliability, small family size, and quiet behaviour.

(d) Landlords seek the maximum allowable <u>net</u> rent increases consistent with the prevailing rules, as applied, where all the legal, accounting, and other costs of notice, hearings, and appeals are considered offsets to potential gross gains.

(e) Unlawful rent increases are sometimes made possible by intimidation, by the "extortion" of key money or its equivalent, by tenants' (especially potential tenants') ignorance, or by their acquiescence in the face of the high transaction costs of appeals.

(f) Landlords and tenants contribute money or time to

lobby groups or proceed on their own in order to secure favourable rule changes or prevent unfavourable rule changes. Such lobby groups may assist their individual members in particular cases, especially when the cases are thought to be potentially precedent setting.

Lobbying costs include office rent, salaries, professional fees, the cost of publishing and distributing materials, and, conceivably, contributions in cash or kind to political parties or influential politicians or administrators.

(g) Initially, at least, prospective tenants of controlled rental accommodation incur greater search and queuing costs (primarily time and travel costs) when there is excess demand than when there is not.

(h) Until landlords eliminate their losses, tenants in rent-controlled accommodation obtain a kind of rent subsidy. However, because of the deadweight loss attendant upon in-kind subsidies, the value of the subsidy in individual satisfaction (utility) terms is less than the dollar difference between the controlled rent and the hypothetical market- determined rent. This point is explained in the next Section.

THE ECONOMIC EFFICIENCY ARGUMENT[3]

It is nearly impossible to find a respected economist who has a good thing to say about price controls in general or

rent controls in particular.[4] Indeed, price controls are often cited in elementary textbooks as examples of bad economic policy. Yet price controls exist in many jurisdictions. The usual explanation given by economists for this state of affairs may be captured in one word, "politics". In this context, "politics" is a term of derision, denoting a short-term, expedient, and self-serving decision by elected representatives.

Economists disdain price controls as a self-inflicted wound -- a needless source of economic inefficiency. Many economists also believe that controls are unfair, in that their costs and benefits are distributed unequally among individuals in the same circumstances. Under rent controls, for example, rich and poor tenants can obtain the same benefits and rich and poor landlords can suffer the same losses. Those who are fortunate enough to be renting when controls are introduced obtain a benefit not enjoyed by those who later wish to become tenants. Similarly, those who hold titles to rental accommodation properties suffer a loss when controls are introduced, while those of equal net worth who hold their wealth in other forms escape without loss.

What would seem to be the most convincing equity argument for rent control arises from the exclusion of imputed rents for owner-occupied housing from the personal income tax base. Consider two individuals with the same income and net worth. Each holds a $200,000 bond that yields $24,000 annually. Personal income taxes of $12,000

are levied on this yield, leaving an after-tax interest income of $12,000. Now, suppose that one individual sells his bond and buys a house with the same market value -- $200,000. If the house is rented, it will bring its owner an income of $24,000 per year after expenses. If the house is occupied by the owner, the rent forgone is not included in income and is therefore not taxed. Thus the owner-occupier can occupy twice the quantity or quality of accommodation as the bond-holder, whose rent must be paid from after-tax interest income. And this calculation does not take into account the fact that capital gains on principal residences are untaxed. Equals, defined in terms of income or wealth, are not treated equally under the personal income tax system, which confers a conspicuous advantage on the owner-occupier of residential accommodation.

Rent control could be looked upon as a crude way of giving a benefit to tenants that "matches" the tax advantage given to owner-occupiers of residential accommodation. Two points are worth noting, however. First, although the signs of the benefits are the same, their magnitudes are most unlikely to be similar. Second, while the costs of excluding the imputed rents of owner-occupied residences are borne by all other taxpayers, the costs of rent control are largely borne by landlords -- a diverse subset of all investors. Consequently, this equity argument for rent control, although not entirely baseless, is extremely tenuous. No doubt it can also be argued that advantages to

landlords, particularly the landlords of old buildings, arise from market imperfections. And no doubt these arguments too could be used to rationalize the conferring of a crudely matching benefit on tenants.

The concept of equity is important, but the efficiency issue is no less so. However, the concept of economic efficiency is one that requires some explanation.

I shall try to put a complex argument as briefly and simply as possible. Conventional economics defines economic efficiency in terms of the concept of Pareto optimality, which starts with the assumption that the satisfaction obtained by individuals from the consumption of goods and services is determined solely by their own consumption and is unaffected by the consumption of others. Individuals are neither jealous of nor empathetic with others. An economy is Pareto optimal -- that is, "efficient" -- when one individual cannot be made better off (have a higher level of satisfaction or utility) without making another individual worse off. This means, in effect, that the winners cannot compensate the losers and remain winners. This economic efficiency criterion avoids the necessity of comparing the absolute magnitudes of the additional utility of winners and the subtracted utility of losers.

It can be shown that Pareto efficiency will exist under certain simplifying assumptions or conditions, including no uncertainty, complete and costless information, no transaction costs, and perfect competition in all markets. In the real world, these conditions seldom, if ever, hold

completely. Their failure to hold may be the consequence of the inherent limitations of some real markets, limitations usually called "market imperfections". Government intervention that eliminates or offsets market imperfections can increase economic efficiency. Governments can also provide "second-best" solutions -- "first-best" solutions wholly eliminate market imperfections. However, neo-classical economists feel that, for the most part, government intervention has a perverse effect on economic efficiency even when its stated objective is to improve efficiency. The cure, in some circumstances, can be worse than the disease, leaving aside the relatively rare instances in which policy errors are based on erroneous information or analysis. More commonly, in the neo-classical view, the stated market imperfection is simply an excuse for an action undertaken for other, unstated and other, unstatable reasons.

Government intervention is also frequently rationalized as a necessary means to the achievement of some distributional objective, such as "adequate housing for all at an affordable cost". The economist has nothing particularly useful to contribute to a debate concerning the merit or lack of merit of an objective of this sort -- except perhaps, as in this case, the observation that the objective is too vague for operational purposes. What an economist can say, within his field of professional competence, is that all practical attempts by governments to change the

distribution of wealth or income (where income is defined to include the imputed value of benefits in kind) involve costs in the form of sacrificed economic efficiency.

However, some methods of intervention for distributional purposes are more costly in efficiency terms than others. Not surprisingly, economists argue that the least inefficient means should be chosen to attain a given distributional objective. Because distributional objectives are so often couched in vague, rhetorical terms and because the means adopted are often far from being the most efficient available, it is difficult to escape the suspicion that the real object of intervention is partisan advantage -- the capture of electoral support. Why this should be reprehensible in a democracy is unclear, unless the majority are exploiting a minority.

There are three reasons why most government intervention undertaken in order to accomplish changes in the distribution of income or wealth reduces economic efficiency. The first is that government intervention, whether it proceeds by means of explicit taxes or subsidies or by means of regulations that indirectly impose taxes or confer subsidies, drives a "wedge" between the market price that would otherwise prevail and the post-intervention price. This means, for example, that when rents are reduced through rent control the quantity of rental accommodation demanded at the reduced price will be increased and the quantity of accommodation supplied at the reduced price will be reduced, other things being equal.

While those fortunate enough to occupy accommodation with a controlled (lower) rent do obtain a benefit, they would be better off if the benefit were provided in cash. Not only would they probably rent more accommodation, but they would buy more of other things as well. In other words, individuals would be better off with a cash benefit than with an in-kind benefit because they would be able to choose a bundle of consumer goods and services that yielded them more satisfaction.

The cash transfer has another advantage and one disadvantage relative to an in-kind benefit. It has been claimed that in the past, when there was no rent registry, landlords sometimes took advantage of tenant turnover to illegally raise rents for new tenants. To the extent that these allegations are valid, in-kind transfers made it more difficult for the original tenants of controlled accommodation to adjust the quantity or quality of their accommodation to suit their changing needs, since they were likely to be confronted with illegally raised rents.

The disadvantage of general cash subsidies relative to rent controls is the possibility that in the short run, when supply is inelastic (price insensitive), the increase in incomes will be quickly reflected in higher rents. Landlords will absorb a significant fraction of the subsidy, benefitting as much or more than tenants. However, given the ease of entry into the construction industry, and hence the competitiveness within the industry, one would expect

the higher rents to eventually generate an increase in the supply of rental accommodation, bringing rents down relative to what they would otherwise have been. Nevertheless, the prospect of immediate rent increases following the introduction of a rent subsidy scheme is likely to bulk large in the public perception of the scheme and make it unattractive as a practical alternative.

Government intervention through controls also leads to economic inefficiency because of its effects on supply. Artificially lowered rents reduce the return on investment in rental accommodation. This means less maintenance, less renovation, and less new construction of rental accommodation, <u>even if new construction is not subject to rent control</u>. This follows because of the risk that the rules will change and the controls will be extended to new construction. Should the risk be perceived as substantial, resources will be diverted to the production of other things, which now offer a relatively higher return. This shift will lower the prices of these other things, to the benefit of those who consume them. But these gains will not offset the losses in consumer utility that result from the reduced stock of rental accommodation. Hence the value of total output will fall.

Economic efficiency losses of this kind are usually called "deadweight losses" or "excess burdens". They arise because the tax subsidy "wedges" created by controls distort prices. The result is that, at the margin, consumers demand too much of the subsidized item relative to other things and

too little of the taxed item is supplied because of its opportunity cost.

The risk that potential investors attach to the possibility that rent controls will be extended to new or other uncontrolled accommodation, or that existing controls will be rescinded, is crucial to the supply impact of the controls. Historic costs are irrelevant to the decision at the margin whether or not to maintain, renovate, or demolish controlled accommodation. Controls impose a capital loss on landlords when they are introduced. They are irrelevant to decisions about future investments at the margin unless the terms of the original intervention change.

Another important consideration is the specific manner in which the cost pass-through rules are applied. Suppose, for example, that a landlord regularly undertakes increased "one-shot" maintenance expenditures just before he applied for rent review. These expenditures may be embedded in the new, higher rent base, even though the costs will not be repeated until the next review. In practice, therefore, rent review gives him a higher rate of return than theory would suggest. Similarly, suppose that superficially "renovated" units are readily accepted as "new" and, hence, uncontrolled units; again, the actual application of controls will have a less adverse effect on expected rates of return than the rules would seem to enjoin. In short, because historic losses are relevant to investment decisions only to the extent that they affect risk perceptions, and

because administrative practice may differ significantly from legislative theory, excess burden (deadweight losses) may be considerably less than might be supposed at first glance.

Finally, government intervention aggravates the efficiency loss associated with information (search) and transaction costs. Even without government intervention, these costs can be high enough to preclude certain kinds of contracts (exchanges) -- that is, the information and contracting costs can more than offset the potential benefits to the parties in a voluntary exchange. For example, insurers will not enter into a contract if the insured is likely to secure a net benefit from the occurrence of the "risk". Policing claims for profitable self-inflicted damages would be prohibitively costly; or else the premiums would be too high to appeal to those who did not intend to give fate a helping hand.

In free markets, the existence of voluntary exchange is evidence of a benefit, to one party or both parties, net of information and transaction costs. Otherwise, a mutually acceptable bargain could not be struck. This formulation assumes that both parties to a contract are fully informed. Suppose, for example, that a landlord unilaterally terminates a lease at great expense to the tenant -- an expense that the landlord ignores. The tenant is assumed to have taken this risk into account when he signed the contract, for by signing it he signified that bearing the risk would, at least, make him no worse off than not bearing it.

Government intervention, such as the imposition of price controls, generates additional information and contract costs. More resources are needed for searching, contract bargaining, and contract enforcement. Given a fully employed economy (an important assumption), this diversion of resources means that smaller amounts of other things that individuals want are produced and distributed.

To be more specific, rent control lowers vacancy rates by reducing the supply of rental accommodation and by increasing the quantity demanded. Relative to those who seek uncontrolled rental accommodation, those who demand but do not have controlled accommodation are faced with higher search costs, are more likely to be confronted with demands for key money (or the equivalent), and encounter greater discrimination, as landlords eliminate all but the most desirable tenants from a longer list of applicants. In addition, tenants of rent-controlled accommodation are confronted by the actions of landlords seeking to minimize their losses: reductions in maintenance; the use of exaggerated cost estimates to justify higher rents; the conversion of rental accommodation to condominiums, hotels, or single family units; the demolition of existing units followed by construction of new rental accommodation at higher, uncontrolled prices. Landlords <u>and</u> tenants use up time, effort, and physical goods in a never-ending battle. Tenants fight to retain the benefits of controls and landlords fight to escape the burdens of controls. Some

economists call such activities "rent seeking".

Rent seeking encompasses two distinct but related kinds of costs: the costs incurred in securing favourable or resisting unfavourable legislation and administrative policies; the costs incurred in securing the favourable application or avoiding the unfavourable application of existing laws and policies. Obviously, lobbying costs can be incurred in the absence of rent control. Procedural costs arise only when a system of controls is in place. A brief discussion of rent seeking follows.

THE THEORY OF RENT SEEKING[5]

Rent seeking, a term coined by Anne Krueger (1974), has nothing to do with a landlord's periodic descents on his tenants. Nor does the term refer to the pursuit of economic rents as these rents are normally defined. Economic rents are the return over opportunity cost for something that is inherently in fixed supply and whose market value is therefore determined entirely by demand.[6] "Rents" in the context of "rent seeking" are non-exclusive rights to income or wealth that have been created, directly or indirectly, by government intervention. Government, the ultimate source and protector of all rights, has the power to convert an exclusive right to the control of some valued thing -- accommodation, for example -- into a non-exclusive (unassigned) right. Rent seeking is the struggle to either secure a share of a non-exclusive right or to avoid the loss

of such a share. This struggle necessarily involves transaction costs -- that is, an expenditure of real resources.

Rent seeking may therefore be thought of as an investment of real resources by individuals or groups in attempts to obtain favourable (or to avoid unfavourable) government decisions.[7] These decisions involve the redistribution of income or wealth rather than the creation of income or wealth. To those who assume that more output is better than less and that the interpersonal distribution of that output is of no economic importance, the investment of real resources in rent seeking is sheer waste.

Rent seeking can take place by a variety of means and at three levels. That is, it can involve:

1. investment by individuals or groups of individuals in lobbying for favourable legislative or regulatory changes;
2. investment by individuals or groups in securing favourable decisions under the discretionary provisions of existing laws and regulations;
3. investment by politicians, by bureaucrats, and by those who are striving to obtain offices in the expectation of securing personal benefits in case or in kind from increased government revenues.

It is important to recognize that rent seeking can be positive or negative: investments are made in the

expectation of maintaining an existing benefit or obtaining a benefit not currently provided, or in the expectation of reducing a current cost or minimizing a future cost.

An example may clarify these differences. Suppose there is a regulatory authority empowered to licence broadcasting. Suppose that licences are not auctioned off to the highest bidder but are granted at the discretion of the authority. Those seeking licences will engage in rent-seeking activity (that is, they will invest in lobbying for the license) -- a once-and-for-all occurrence rather than an ongoing process. If all of the parties know what each of the others is doing, they will be able to determine the optimal investment in this "lottery". That is, if all of the parties know what a license is worth (and it is potentially worth the same amount to each party), and if they all know how many groups are competing for it on the same terms, they will invest in competing with each other a sum just equal to the <u>expected</u> present value of the license, taking the probability of success into account. On the other hand, if information is imperfect and strategic behaviour therefore possible, the sum of the investments (bids) may equal, exceed, or fall short of the present value of the license. Note that the investments (bids) are in real terms: the time of lawyers, accountants, and PR experts, the cost of luncheons, "gifts", and travel.

Suppose instead that the licence is sold at auction to the highest bidder, an arrangement that increases government revenues. Depending upon the <u>de facto</u> rules, this increase

may provide an opportunity for some officials, elected or appointed, to obtain rents -- returns over and above their returns in alternative offices -- through the "dissipation" of the licence proceeds. These returns might take the form of higher salaries, less work, or more perquisites of office. Should such returns be available, there will be competition for the offices that provide them. This competition might entail higher campaign expenses for elected officials or educational and training expenses for appointed officials.

Still another possibility exists. Suppose that the licences are auctioned and the officials are unable to capture a share of the proceeds. The additional government revenues will then be sought by individuals not in government, who will attempt to capture a share of these rents in the shape of tax reductions or benefits in cash or kind. This type of rent seeking is similar to the lobbying activities of those who seek licences issued on a discretionary basis.

The motive for rent seeking, as I have defined the term here, is self-interested -- the same "rationality" of choice that, in market economics, leads entrepreneurs to seek maximum profits, workers to seek maximum wages, investors to seek maximum returns, and buyers to seek minimum purchase prices for goods and services. What is different is the institutional setting. In a market setting, the pursuit of self-interest _usually_ (and inadvertently) also produces a

desirable social result -- an efficient allocation of resources. In a non-market setting, these self-interested, rational actions have an adverse social result -- resources are used up ("wasted") in the fight over the distribution of the (smaller than necessary) output "pie" of desired goods and services.

The theory of rent seeking (although not the term) originated with Gordon Tullock (1967), one of the founding fathers (with James Buchanan) of the "Virginia School" of public choice economics. The Virginia School is the ideological twin of the Chicago School of neo-classical economics, but the former emphasizes the analysis of non-market institutions and the latter concentrates on market institutions.

To put the matter in a slightly different way, both schools are based on neo-classical liberal underpinnings, which emphasize the virtues of markets as resource allocators and the vices, political, social, and economic, of non-market institutions in the same role. Both schools want to minimize government intervention. Buchanan and Tullock (1962) go so far as to advocate an amendment to the U.S. Constitution under which the passage of all legislation would require a 70 to 80 per cent majority (ideally, unanimity), so that it would be more difficult for the "majority" to "coerce" the minority. However, "majorities" are usually temporary coalitions of minorities that have arrived at a set of side payments among the member groups that compensate the losers within the coalition. Obviously

it would be extremely difficult to secure the support of such a coalition for a constitutional amendment that would reduce its ability to extract net benefits from (inflict non-compensated losses on) minorities. After all, it is the power of majorities to extort benefits from minorities that provides the incentive for the members of a coalition to join it in the first place.

More fundamentally, one can object to the assertion of the theorists of rent-seeking that the consumption of resources in the struggle over distribution shares is a total social waste. Few would argue that a larger pie of total output of desired goods and services is better than a smaller pie. Nor is there any doubt that the battle over shares reduces the size of the pie relative to its want-satisfying potential. However, the conflict over shares is endemic except <u>within</u> highly prescriptive, traditional societies in which one's share is determined by, for example, one's birthright. Even so, the prescriptive distribution does not apply to those who are not members of the group. War is the "resource-wasting" consequence, just as revolution is a common consequence when disparities in the distribution of wealth within a society are perceived to be unfair. Wars and revolutions also waste resources relative to the Buchanan - Tullock ideal.

The issue is not whether governments should or should not be allowed to intervene in market systems; such intervention is inherent in society. While it is true that

government intervention, whatever its ostensible purpose, often provides an opportunity for rent-seeking behaviour, it is also true that other methods of battling over the inter-personal distribution of goods -- such as war and revolution -- are usually even more costly in resource dissipation terms. What we need is a resolution of the distributional conflict, within existing institutions, by means less costly than the ubiquitous rent-seeking behaviour we currently observe. Highly emotional phrases such as "social waste" and "resource dissipation" do more to discourage the consideration of alternative arrangements than they do to encourage the view that the often chance-dominated distributional outcomes of market processes are superior to all of the alternatives.

There is, not surprisingly, a positivistic dimension as well as a normative dimension to the emerging theory of rent seeking. Indeed, the intellectual progenitor of the theory is Stigler's work (1962) on the behaviour of regulatory agencies. Stigler empirically tested the hypothesis that such agencies are usually "captured" by those they supposedly control. From there it was a relatively short step to Tullock's 1967 normative article, "The Welfare Costs of Tariffs, Monopolies and Theft". This led to a positivistic analysis by Posner (1975) of "The Social Costs of Monopoly and Regulation". Krueger's phrase-coining article, "The Political Economy of the Rent Seeking Society" (1974), provided some empirical estimates of rent seeking arising in India from foreign exchange import controls.

McCormick and Tollison (1981), in a chapter entitled "Wealth Transfers in a Representative Democracy", tested the hypothesis that in the United States state legislatures with two chambers of equal size are more vulnerable to the rent-seeking activities of lobbyists than legislatures with chambers of unequal size or with only one chamber.

Cheung (1974) has developed a theory of price control that focuses on the implications of the distinction between exclusive and non-exclusive rights. According to Cheung, an economic good, such as rental accommodation, is "private property" when ownership confers three interrelated rights:

1. The exclusive right to use, or to decide how to use, the asset. This entails the right to exclude others from its use.
2. The exclusive right to the income generated from the use of the asset.
3. The right to transfer or freely alienate the right to ownership by any form of contract chosen by the owner. (Cheung 1974, 57).

Cheung argues that Ontario's system of residential rent review restricts the second of these rights, since it limits the magnitude of the rent that the landlord can charge for controlled units. "Thus the value of a good will decline either if its most valued use is restricted, or if its transferability, in one way or another, is constrained by

law. A free market, by definition, requires not only the absence of legal regulation on contractual terms but also the absence of restriction on the choice of contracts." (Ibid., 57).

Cheung postulates that "each individual will utilize his private property in such a way as to generate the highest real income (money income corrected for inflation)" (Ibid.). Thus the owner of private property will enter into contractual arrangements for its use with other individuals, if this alternative promises to yield a higher return than using it himself. On this basis, Cheung formulates the first of two propositions.

> Proposition I: When the right to receive income is partly or fully taken away from a contracting party, the deviated income will tend to dissipate unless the right to it is exclusively assigned to another individual. The dissipation of non-exclusive income will occur either through a change in the form of using or producing the good, resulting in a decline in its value, or through a change in contractual behaviour, resulting in a rise in the cost of forming and enforcing contracts, or through a combination of the two. (Ibid., 58)

This can be paraphrased as follows: when restrictions are imposed on the flow of rental income that can be obtained from the ownership of real property, unless the diverted income (the difference between the market rental and the lower controlled rental) is assigned exclusively to a particular individual, it will tend to be "dissipated". In this context, "dissipated" means either that the property

will be put to a use that commands a lower market price (e.g. commercial rather than residential) or that real resources will be used up in attempts to minimize the loss (in the case of the "losing" landlords) or retain the benefit (in the case of "winning" tenants). The phrase "value reducing changes in use" can be taken to mean "a reduction in value relative to an uncontrolled use but an increase in value relative to a controlled use". Changes in contracting behaviour that increase the costs of reaching agreements or enforcing contracts are so-called transaction costs.

The significance of the creation of a "non-exclusive" portion of the income generated by a residential unit can best be seen through some examples. Suppose that an apartment would yield a market rent of $100 per month but that rent controls restrict the rent to $60. The difference is non-exclusive in that the landlord's income is what it would be if he only owned 60 per cent of the apartment. The landlord's income would be unaffected if he were to transfer to the tenant exclusive ownership of 40 per cent of the space of the apartment or 40 per cent of the shares of a corporation that held the apartment. Another possibility would be to fix in dollar terms the rent to be received by the owner and permit the original tenant to sublet the apartment for whatever it would bring -- the difference between the fixed rental to the owner and the sub-lease rental would be obtained exclusively by the original tenant.

Under any one of these three arrangements, the property would be used as though rent control did not exist. That

is, the use of the property that brought the highest rate of return would be the same whether the landlord retained the 40 per cent of the exclusive rights or the tenant obtained them. But while rent control would not affect the use of the property if any of these three alternatives were available, it would alter contractual arrangements and therefore raise transaction costs. Yet these costs would probably not be large relative to the transfer of wealth from the owner to the original tenant. Which, if any, of these options would be chosen would depend upon both the specific rules of the rent control scheme and other rules, such as zoning or tenancy rules. The point is that because all parties will seek to minimize their loss or maximize their benefits under the constraints of rent control and other rules, they will seek to minimize the costs involved in fighting for advantage. That is to say, they will seek to minimize the dissipation of non-exclusive income ("rent" as in "rent seeking"). This conclusion leads Cheung to the second of his propositions:

> Proposition 2: Given the existence of non-exclusive income and its tendency to dissipate, each and every party involved will seek to minimize the dissipation subject to constraints. This will be done either through seeking alternatives in using or producing the good so that the decline in the resource value is the lowest, or through forming alternative contractual arrangements to govern the use or production of the good with the least rise in transaction costs, or through the least costly combination of the two procedures. (Ibid., 61)

This too can be paraphrased: tenants will try to maximize their benefits and landlords will try to minimize their costs by changing the use or production of the property, the contractual arrangements, or both. But they will do these things in the least costly manner within the prevailing rules.

For example, suppose that none of the three arrangements described above are permissable. The owner will seek to minimize his loss by, say, converting to the next best use or selling the apartment as a condominium for owner occupancy. If these avenues are blocked by rules, the landlord can allow the apartment to deteriorate through inadequate maintenance until the controlled rent equals the new, lower market rent. This approach constitutes a change in production; that is, the owner disinvests and produces less accommodation. Other alternatives are owner occupancy, the requirement of key money, or the extraction of other side payments through, say, the compulsory rental of furniture above the market price. Still another possibility is discrimination in favour of the prospective tenants who are likely to be the most reliable in terms of prompt payment of the monthly rent, likely to give the apartment the least wear and tear, or both. The landlord will choose the means of minimizing his loss that involves the minimum resource cost given the prevailing rules. Again, one can imagine rules or other considerations that preclude any of the foregoing arrangements. When there is excess demand,

queuing may be the best legal way of rationing vacant apartments. Theoretically, prospective tenants will try to minimize queuing costs by, say, paying someone whose opportunity costs are lower to go from place to place putting their names on a waiting list and then immediately subleasing accommodation to others.

It should be noted that Cheung's language is somewhat idiosyncratic. For example, when non-exclusive rights are eliminated, by disinvestment through inadequate maintenance, Cheung calls this "dissipation". Similarly, entering into a key money contract eliminates the non-exclusive right and further "dissipation". In other words, Cheung uses the term "dissipation" to categorize the resources used up in the effort to eliminate non-exclusive rights or in the struggle for a share of the benefits from them, but the costs need not equal the value of the non-exclusive rights. Thus a key money contract eliminates the non-exclusive right but the contracting cost *per se* -- the dissipation -- is relatively small.

Cheung derives three corollaries from his propositions.

1. The more restrictive are the rules, the more costly are the transaction costs. Thus, key money, if not outlawed, is less costly in resource terms than say, conversion to condominium ownership contracts; and these conversions, if permitted by law, are cheaper than extensive renovations undertaken to convert controlled into uncontrolled units. In all cases, the

redistributive intent is frustrated, but at even higher economic costs.

2. Similarly, competition among prospective tenants reduces transaction costs -- that is, it reduces the costs of bargaining.
3. Contractual costs increase with the number of contractual participants.

Cheung's formulation of the theory of rent seeking, which was undertaken for the explicit purpose of analyzing residential accommodation rent controls, differs in one important respect from the original Tullock formulation. Cheung and Tullock agree (although they do not use the same terminology) that rent seeking arises because of the existence of non-exclusive rights to income. In the case of residential rent controls, these non-exclusive rights are "created" by government in the sense that they would not exist in a world without government rules that give rise to a gap between market price and controlled price. According to Tullock, the real resources deployed in securing the rents -- the non-exclusive rights -- just equal the value of the rents. The rents are thus totally "dissipated". However, in Cheung's view the parties (landlords and tenants, actual and potential) seek to minimize the extent of the dissipation of the non-exclusive values. This suggests, of course, that rents need not be and probably are not entirely dissipated.

Let me put the matter in a slightly different way. If rent control were based on a few easily ascertained facts and unequivocal rules, if hearings were quick and simple, if all avenues for landlord "escape" (such as conversions and reduced maintenance) were decisively closed, and if all available accommodation were invariably offered on a first-come (to a central registry?), first-served basis, "dissipation" would probably be a relatively trivial matter. The non-exclusive rights would be relatively cheaply transformed into exclusive rights. The degree of redistribution achieved would depend, of course, upon the particular rules and their application. One thing is reasonably certain: the fewer and simpler were the rules, the more rough and ready would be the justice dispensed because many differences in seemingly relevant circumstances would inevitably be ignored.

Formal taxation is to some extent analagous to rent regulation considered from the landlord's point of view. Poll taxes create little in the way of non-exclusive liabilities compared with, say, modern personal income taxes. Yet short of moving to another jurisdiction (or suicide!) there is no escape from a poll tax liability, while personal income tax systems offer many avenues for tax avoidance. The substitution of leisure (untaxed) for work (taxed) and of owner-occupied accommodation (untaxed) for financial assets (taxed) are but two of a multitude of available means of reducing one's income tax. However, poll taxes are generally thought to be grossly unfair, since they reflect

neither ability to pay nor benefits received. Thus the replacement of personal income taxes by a poll tax would reduce resource costs but increase social "costs".

Until recently, economists have ignored this important resource allocation effect of rent control, namely the increase in transaction or "rent seeking" costs. These costs are over and above the inefficiency costs generated by in-kind subsidies that are less valuable than cash and by taxes that result in the devotion of too few resources to the provision of rental accommodation relative to other things -- the traditionally considered sources of inefficiency. Obviously the transaction costs associated with rent control are by no means trivial, given the time and effort devoted directly to the rent review process and the costs to landlords and tenants of lobbying for changes in the rules. What cannot be determined deductively, however, is the magnitude of the transaction costs relative to the value of the taxes and subsidies resulting from rent control. The following section presents some estimates -- some extraordinarily crude estimates -- of these transaction costs.

COSTS AND BENEFITS TO SOCIETY

It is widely believed that some redistribution of income and wealth from the affluent to the poor should take place (see Fallis 1983). To the limited extent that renters have lower

incomes and less wealth than homeowners and that those who are landlords (directly or indirectly) have above-<u>average</u> incomes or wealth, the imposition of rent control in Ontario probably did contribute, at least at the outset, to the desired outcome. Subsequent developments -- the conversion, demolition, and deterioration of controlled properties, the construction of rental properties not subject to rent review, and the adoption by some of the various techniques for evading rent increase limitations -- have no doubt reduced the extent of the redistribution actually accomplished.

Against this temporary non-economic benefit must be weighed two costs, one economic and the other non-economic. Although the redistribution of some income and wealth from the wealthy to the poor is an objective shared by many, the method of accomplishing it is not value free. Equal treatment of equals is a long-standing rule of equity, and it too is widely held. Rent control, as it was actually applied, offended against this rule. Two individuals alike in all other relevant respects were treated unequally if one occupied and the other owned rent-controlled property. Some who were hurt were as much in "need" of help as those who helped, and some who were helped were as "deserving" of hurt as those who were hurt.

In all likelihood, the achievement of the redistribution effect also imposed <u>some</u> economic costs through a worsening of the allocation of resources, although there are two potentially mitigating factors. Given full employment and no market imperfections, the two potentially important

offsetting considerations, all government intervention leads to economic inefficiency except under impossibly stringent conditions. Rent control, which necessarily has the effect of simultaneously imposing taxes and bestowing in-kind transfers, changes the allocation of resources in two ways: first, it diverts resources from more to less utility-producing uses; second, it diverts resources from utility-producing to non-utility-producing uses in the scramble for non-exclusively assigned benefits (with their attendant transaction costs, including the government's administrative costs).

The transaction costs associated with rent control will be explored further below. The other cause of economic inefficiency, the simultaneous imposition of taxes and subsidies, arises, it might be recalled, for several reasons. Quite apart from any effects of income and wealth redistribution, some people occupy more space in a controlled market than they would in an uncontrolled market; others occupy less. Because controlled accommodation is "cheap", those who have held it from the outset will be induced to stay on, even though they may have more space than they currently need. They would prefer the cash equivalent to the implicit rent subsidy. Those unable to find controlled rent accommodation face higher rents in the uncontrolled sector and rent less accommodation than they would rent in a free market. Both households are worse off than they need be, given the available resources.

Only if the utility losses generated by economic inefficiency (which are unrelated to income redistribution) are more than offset by the sum of the utility gains of those subsidized (the "poor" tenants!) and the utility losses of those taxed (the "rich" landlords!) can a net gain in overall utility result. Whether or not the redistributive effects of the taxes and transfers increase utility is a subjective matter and therefore one that cannot be determined by analysis.

The mitigating circumstances may offset or preclude some or all of these economic inefficiency costs. Because the imposition of rent control prevented a great deal of the short-term household movement that would otherwise have resulted from a sharp but temporary increase in rents relative to prices generally, some transaction costs were avoided. Because resources have been unemployed for sustained periods since October 1975, when rent control was introduced, the opportunity cost of the misallocation of employed resources has, in effect, been zero. When productive resources are idle, the concept of inefficiency does not have much meaning, since with full employment in a global sense there could be more of all producible goods and services.

However, even though aggregate unemployment, for at least part of the period since October 1975, has made the notion of allocative efficiency irrelevant, it is difficult to be sanguine about this presumably temporary reprieve from inherent costs. Moreover, if rent control has reduced new

residential construction relative to what it would otherwise have been, even in a period of unemployment, society is that much worse off. Rent control has exacerbated a bad situation.

There is no known way, except possibly by the aid of a complex, general equilibrium econometric model of the Ontario housing sector, to quantify the economic costs and benefits of rent control to society. Such estimates, even if they were available, would not take into account the non-economic benefits and costs of an increase in redistribution accomplished, admittedly, by flawed means.

Table I sets forth an extremely crude estimate of some of the transaction costs entailed by the Ontario rent review process I have used. The year 1981 was chosen simply because this is the year for which hearings data are available and to which the most recent estimate of the number of controlled rental accommodation units applies.

The only reliable firm cost data are for the actual expenditures of the Residential Tenancies Commission, which amounted to $4,975 thousand in fiscal 1981-1982. Two firms provided data on landlord <u>hearing</u> costs: Jordan and Geisel Management and the Sun Life Assurance Company (see Jordan 1984 and Eby 1984). The former firm provides estimates of the fees charged of $35 per unit for medium-sized buildings and $25 per unit for large buildings. When one-time expenses are added to the consulting fee, the unit costs are $49 (say $50) for medium-sized buildings and $35 for large

TABLE 1

Estimated Transaction Costs of Ontario Rent Review, 1981

Hearings	Number of Units (000)	Landlord Unit cost	Landlord (000) $	Estimated costs Tenant (000) $	RTC (000) $	Total (000) $
Whole building review						
Small buildings (6 or less units)	4.5	65	292			
Medium-sized buildings (7 units or more on three floors - no elevators)	16.5	50	825			
Large buildings (7 units or more on more than three floors - elevators)	56.3	35	1,970			
Special	5.4	65	351			
Tenant initiated	0.01	50	5			
Rent increase rebates	0.2	50	11			
Appeals	11.0	50	550			
Conciliation	1.1	25	28			
Total hearings costs			4,032	2,000	4,975	11,007
Lobbying @ one-third of the above costs			1,344	667		2,011
Total hearings and lobbying costs			5,376	2,667	4,975	13,018

NOTE: Units are 1981 data; cost estimates are in 1984 dollars.
SOURCES: Commission of Inquiry into Residential Tenancies (1984, Tables 1,7A, 7B, 8, and 10); Jordan (1984) and Eby (1984).

buildings. Sun Life's estimates work out to $65 per unit for a two hundred unit (large?) apartment building. This figure is 85 per cent greater than the Jordan and Geisel unit cost estimate for large buildings! However, because the latter firm does not indicate the number of units associated with its division of buildings into "medium" and "large", the disparity could be the result of a difference in definitions. At any rate, out of an abundance of caution, I have chosen the lower, Jordan and Geisel, estimates. Given that much of the cost of whole building review is fixed (invariant with respect to the number of units in a building), the landlord's unit cost for "small" building review is assumed to be $65 -- which is probably modest. In any event, so few reviews fall within this size category that they have little effect on the overall results. I have treated "special" buildings in the same manner as "small" buildings.

The RTC does not differentiate by unit size the number of tenant-initiated hearings and appeal hearings. A landlord cost of $50 per unit -- the whole building review hearing cost for medium-sized buildings -- would seem to be appropriate, in the absence of any information to the contrary. There were about eleven hundred successful conciliation proceedings. I have assumed that the cost of these proceedings was $25 per unit -- half the unit cost of regular hearings for medium-sized buildings.

On the foregoing basis, the RTC hearings and conciliation proceedings cost landlords an estimated $5.4 million in

1981. Because the unit costs are expressed in 1984 dollars and the number of hearings has increased sharply from 1981 to 1984, this figure understates the current cost.

There is apparently no available information whatsoever on tenant costs, other than the budget of the Federation of Metropolitan Toronto Tenants' Associations. All that can be done to estimate the RTC hearing costs for tenants is to make some semi-plausible guesses. One straightforward technique is to assume that tenant costs are some stated fraction of estimated landlords' costs -- that is, about $2 million.

As a kind of cross check, I have adopted another approach as well. The method and results are given in Table 2. I have arrived at a primitive estimate of a tenants' association participation rate on the basis of the number of controlled rental units in each size category (a total 915,000 units in 1981 plus 100,000 units added for under-reporting of small and special units -- see Commission of Inquiry into Residential Tenancies (COIRT) 1984, Table 13 for the method). Small buildings and special buildings are assumed to have only a 5 per cent participation rate; medium-sized and large buildings are assumed to have participation rates of 60 and 75 per cent, respectively. The great disparity between the small and the special on the one hand and the medium and the large on the other seems justified on the basis of the whole building review hearing rates, which in 1981 were less than 2 per cent for small

TABLE 2

Estimated Hearings Expenditures of Participating Tenants in Controlled Units, 1981

	Number of controlled units (000)	Estimated participation rate	Contributing participants (000)	Whole building review hearing rate
Small	309.4	0.05	15	0.014
Medium	149.3	0.60	90	0.110
Large	456.1	0.75	342	0.123
Special	100.0[a]	0.05	5	0.054
Total	1,014.9		452	0.081

Hearing costs @ $5/participant per year = $5 x 452,000 = $2,260.000

Lobbying costs @$1/participant per year = $1 x 452,000 = $ 452,000

$2,712,000

[a] Added to compensate for expected underreporting.

SOURCE: COIRT (1984, Tables 1 and 13).

buildings and 12 per cent for larger buildings.

On the basis of these hypothetical participation rates, the number of "contributing" tenants was about 450,000 in 1981. If one assumes that each tenant contributed, on average, in cash or kind (including the imputed value of own labour) $5 per year towards defraying the tenants' portion of the cost of hearings, the total cost to tenants in 1981 was $2.25 million.

The estimate of $5 per year can be looked upon as $25 once in every five years, when a hearing takes place. About 8 per cent of all units are involved in hearings each year. If half of the one million units are never involved in hearings and the other half are involved on average once in every five years, there are about 100,000 hearings per year. The actual number in 1981 was 82,000. The $2.2 million for tenants' hearing cost in 1981 is roughly equal to one-half of the estimate for landlords' costs of hearings.

On this shaky basis, the estimated hearing costs to landlords, tenants, and taxpayers (through the RTC) for 1981 were about $11 million.

Lobbying costs are not included in this estimate, and there is virtually no basis for arriving at any number. The Federation of Metropolitan Toronto Tenants' Associations did note that about one-third of its financial resources of $72 thousand in 1982-83 were devoted to lobbying activities (Robinson 1984). But there is little reason to suppose that this is a valid proportion applicable to landlords and tenants associations per se. Presumably, the Federation of Associations does spend a higher proportion of its budget on lobbying than would a building association or a small local association because of the inordinate spillover effects of such an investment. Despite great misgivings, I have put the lobbying costs at $2 million -- one-third of the estimated hearing costs for landlords and tenants.

Thus hearing and lobbying costs amounted to an

estimated $13 million in 1981.

Still excluded are the extra search costs occasioned by prospective tenants in the face of the excess demand presumably brought about by rent control, at least in the earlier phases of the rent review program.

There are more than one million rental housing units in Ontario. Assuming that the average controlled rent is $400 per month, and that this is only 1 per cent less than it would be in the absence of controls, the annual "saving" to the tenant is $48 per unit. For the province, then, tenant benefits per year would be about $48 million, compared with partial transaction cost of an estimated $13 million. If we double the latter figure to take into account the extra search and queuing costs that result from excess demand (a phenomenon that declines over time), the cost of rent seeking is still only about one-half the rent "saving" of $48 million. If transaction costs are in fact less than gross benefits -- and this would be the case even if our loose estimate of transaction costs were nearly doubled again -- it follows either that the aggregate gross benefit to tenants is relatively small (say 2 or 3 per cent of controlled rents) or that only a small fraction of gross tenant benefits dissipate.

While there is no hard basis for choosing between these two possibilities, casual empiricism suggests that small gross tenant benefits rather than a low rate of dissipation of those benefits is the more likely alternative. There are several reasons why the gross benefits may be less than is

commonly assumed:

1. The high rates of demolition and condominium conversion in the earlier years before this loophole was closed.
2. The opportunities afforded landlords for withdrawing capital through (illegal) inadequate maintenance over nearly a decade.
3. Opportunities open to landlords, in the absence of a registry, to raise rents illegally or to exact "key money" or its equivalent from new tenants when old tenants leave.
4. Opportunities open to landlords to inflate costs for rent review purposes, particularly before limits on increases in financing costs were imposed.
5. Competition from the supply of uncontrolled units that, although higher in rent, are also higher in quality.

It should not be overlooked that in some of these circumstances, such as the third, a landlord and a new tenant can come to a mutually satisfactory contractual arrangement that evades rent control at relatively little cost. They can agree to split the saving in transaction costs. Nor should it be overlooked that there can be, and no doubt are, great variations in the effectiveness of rent review. Strong tenant associations (containing professional members willing to contribute their services for low fees, one might suppose) that face the scrupulous (or frightened

or dilatory) landlords of buildings with low turnover rates may be able to deliver substantial benefits. But the transaction costs, including the imputed value of the tenants' time, is likely to be substantial. At the other extreme, the tenants of buildings with weak or transient tenant associations and unscrupulous, fast-off-the-mark, risk-taking landlords probably gain little, if anything, from rent review.

At least one more situation merits consideration. Conceivably, a strong and credible tenant association could achieve most of its goals, through one decisive appearance at a rent review hearing. The tenants' on-going transaction costs might be relatively low thereafter, since the threat of aggressive tenant interventions in the future would probably forestall any moves by the landlord that were not extremely defensible (that is, modest). It is not possible, of course, to determine how often this kind of thing happens or what effect it has on total transaction costs.

A PUBLIC CHOICE APPROACH TO POLICY-MAKING[8]

Governments should seek to reduce or offset economic inefficiency when it is inherent in imperfect markets or is an unintended side-effect of government policies. They should adopt the means of realizing redistribution objectives that have the least untoward effects on economic efficiency. These are the normative positions of conventional economics. What they ignore are the incentives under

which the makers of public policy actually function. This omission is anomalous, given that the very concept of market efficiency assumes the supremacy of self-interest as pursued by consumers on the one hand and by competing suppliers of goods and services on the other. It is even more anomalous when one considers that increased economic efficiency provides a collective benefit -- that is, an increase in the output of the goods and services people want, relative to what they (hypothetically) would otherwise have, that cannot be captured exclusively by the individuals or groups involved in the decisions that determine its size. Indeed, conventional economics treat the collective decision-making process as though it were the product of some kind of all-knowing, benevolent, disembodied entity that could be reflected in a mathematical expression called a Social Welfare Function. This entity somehow or other aggregates the preferences of the citizenry and makes the "appropriate" trade-offs where necessary. None of this is satisfactory as a basis for the discussion of a concrete policy issue such as residential rent control.

An alternative approach, and one that appears to be more consistent with the basic assumptions and methodology of most economics, is to treat the participants in the making of public policy decisions as self-seeking players in sets of interrelated "games". Each of the several games (politics, lobbying, and the media) has its own set of unique rules, including rules of entry and exit, rules of

play, and rules of reward and punishment. "Game" seems to be the appropriate term because decisions are made in the face of ubiquitous uncertainty about the reactions of others to each player's initiatives. Life is an endless poker game.

Attributes of Voters

Although the vast majority of voters are not active players in policy-making games, they do have an essential role in determining the outcome of these games. The pursuit of self-interest can be assumed to apply to the political activities of individuals in the same way as it applies to their economic activities. Most of the decisions of government officials, elected and non-elected, affect the interests of resident individuals. These interests can be thought of as a bundle of rights to a broad range of things: real and personal property, personal health and reputation, skills, tenure of offices and employments, entitlements to public and private tranfer payments, and access to transportation, communications, legal, and other systems. For want of a better name, I shall call this bundle of rights, less obligations, an individual's Comprehensive Net Worth (CNW). The object for the individual is to maximize his CNW within the constraints of his resources, his maintenance (subsidence) requirements, and the prevailing behavioural rules. Political activities can be thought of as investments made by an individual in the expectation of, maintaining or

expanding his CNW. Political investments take two forms: informed voting and lobbying. Lobbying can be formal or informal; it can be carried out by individuals or through organized groups.

Far from being all-knowing and all-wise, individuals are imperfectly informed and often biased. All individuals have limited intellectual endowments and limited time, effort, and resources to devote to learning; consequently all individuals have gaps in their understanding. It might be expected, however, that an individual's attempts at understanding will be directed largely to those areas of knowledge that encompass the perceived determinants of his CNW. (Note that these determinants can differ dramatically from individual to individual.) For example, an individual is likely to be relatively well-informed about his own occupation or profession, his own accommodation, his own portfolio of financial assets, and his own taxes and entitlements. He is likely to ignore matters, that do not affect or appear not to affect his CNW, if he perceives them at all. In order to minimize his information and decision costs, an individual will use symbols and rules of thumb to communicate vague or complex beliefs and attitudes.

Politicians

It is in a politician's interest -- indeed, it is his proximate objective -- to be elected (or re-elected) as a member

of a government in power and to obtain positions of ever-increasing power and authority in that government. Under the parliamentary system, this process involves the winning of a plurality of votes in a constituency for the party that wins at least a plurality of constituencies. The party with a plurality usually forms the government. When the party holds a majority of the constituencies, it will form the government for a length of time to be determined, within a fixed limit, by the leader of the party.

In casting his ballot, a voter will choose from among the candidates, parties, or leaders the one that he expects to put policies in place that will provide him with the greatest net benefit (or at least net cost) relative to the alternatives. Greatest net benefit means the largest expected stream of net benefits (satisfaction) derived from the individual's present and future holding of rights (CNW), where expected net benefits are discounted for risk. Presumably, it is because voters often apply a larger risk discount to the promises of opposition parties and leaders that governing parties are so frequently re-elected.

The labels of political parties and party leaders are often taken by voters to symbolize a bundle of prospective policy choices. Voters base these perceptions, perhaps, on the parties' and leaders' performance records -- or they may base them on less tangible grounds. The personal attributes and the campaigning of particular candidates, other than the party leader, seem to carry little weight in the decisions of voters.

In order to maximize his likelihood of election or re-election as a member of a winning party, a candidate must try to obtain the nomination of the party with the support of the highest proportion of decided voters in a constituency where such continuing support has been forthcoming for a sustained period -- and he must bear in mind that if he switches party allegiance at a later date he will be viewed with a jaundiced eye by the members of all parties and by many voters. Once he has secured the desired nomination (no simple step), the candidate must work to secure the support of uncommitted voters. This effort is particularly important in so-called "marginal" constituencies --that is, constituencies in which the proportion of uncommitted voters is high.

To put the matter the other way round: parties, leaders, and candidates increase their likelihood of success (the winning of the largest possible number of seats) by seeking to appeal to the uncommitted voters in marginal constituencies. Although voter commitment to a party is presumably a matter of degree and can be shaken, there is less to be gained from trying to change the minds of those who have reached a decision than from trying to convince those who are still undecided. At the extremes, rewarding the faithful is unnecessary and rewarding staunch opponents is futile.

What must politicians or parties do to secure the support of uncommitted voters without alienating committed

supporters? The simple answer is that they have to promise the uncommitted voters benefits that would be realized at the expense of committed opponents and, if need be, committed supporters. Committed supporters can be forced to "contribute" up to the point at which they perceive the future benefits of loyalty to be only slightly greater than the benefits that the opposing party would provide. Alternatively, the costs of the promised benefits can be spread so widely and hence thinly that they will be either overlooked or ignored. Voters' tendency to ignore small per capita costs is reinforced by the fact that it generally costs less on an individual basis to accept these costs than it does to organize in order to fight them.

It must be borne in mind that in this context benefits and costs are reflected in the voters' risk-discounted expected future flows of satisfaction derived from their possession of rights. Perceptions need not be "correct" to affect voter choice. Politicians can generate inconsistent perceptions among different groups of voters because of their voters' ignorance and bias. Many voters are ill-informed about complex matters, particularly matters that are remote from their day-to-day experience, and view the evidence, such as it is, through distorted frames of reference. Thus, promises of shares of the pie are not necessarily constrained by the real size of the pie.

Lobby Groups

When a citizen votes for a candidate who is presumably well disposed towards a policy he favours, he is using only one of many available ways of trying to obtain a desired public policy decision. Lobbying is a common practice in pluralistic societies. It can be defined as an attempt to influence the decisions of people in authority in a direction favourable to the lobbyist. Lobbying is carried out, either directly or through paid agents, both by individuals and by organized groups. It can involve as little as providing the decision-maker with some relevant "facts" that may have escaped his attention. It can involve as much as mounting a major publicity campaign designed to convince tens of thousands of people to support a given candidate or policy. Generally speaking, lobby groups enter into a kind of transaction with decision-makers. The groups offer to supply (or threaten to withhold) something the policy-maker wants, such as campaign funding, in exchange for a favourable decision. Because the interests of different groups of individuals are so often in conflict, there is usually competition for influence over particular decisions. There can be no presumption that all of the relevant interests are represented proportionately. Interests that are widely held may not be pursued by any organized group; interests that are held by only a few individuals may be strongly represented.

Among the most important determinants of the formation

and maintenance of an organized lobby are the following:

1. The _average_ value of the issue at stake to the individuals who have a common interest.
2. The number and geographic dispersion of these individuals.
3. The ability of the organization to provide some benefit, over and above the pursuit of the common interest through lobbying, as an added inducement to membership.
4. The ability of the organization to minimize the number of "free riders" -- people who stand to share in the benefits provided by the organization but who do not contribute their share of the costs.

Although there are no doubt exceptions, the general rule is that, for a given aggregate common interest, the larger is the number of individuals with the common interest and the more dispersed these individuals are geographically, the less likely is the formation of a continuing, effective lobby organization. The reason is that organization costs rise dramatically as numbers rise because of the free-rider problem. In small groups, beneficiaries are easily identified and informal pressure (e.g., social ostracism) will reduce the proportion of free-riders at little cost. This is less feasible in a large and dispersed group. An important exception is the organized group that exists for

some other purpose, such as a medical or law society or a labour union. Because membership in such organizations is a prerequisite for professional practice or for holding some jobs, free-riding is eliminated. The lobbying costs of these groups are but a small addition to the continuing operating costs they incur for other reasons.

Tenants of a building subject to rent controls are presumably easily organized. The numbers are small and geographically contiguous, the potential beneficiaries of a tenant group opposing an application for a rent increase are immediately identifiable, and social pressure -- snubbing -- can be applied to free riders at little cost.

Media

Voter perceptions, it has been emphasized, are the reality of policy decision-making. Those perceptions are greatly affected by the coverage and interpretation of the news by the mass media, notably newspapers and television. News reporting is inherently a highly selective activity. Some news is not gathered at all: it is too costly to obtain, or it is not available to the public, or it is not thought to be enough of interest to enough people to warrant the costs of collection, assembly, and dissemination. The prominence assigned to the news that is gathered is entirely discretionary, as is its interpretation. To some degree, the prominence given to a news item is a kind of interpreta-tion: to give an item great prominence is to assign

importance to it, even if no explicit interpretation is offered. But what criteria do the media apply when they assign a news item "importance"?

Presumably, the primary criteria are the size of the audience a news item will attract and the intensity of the attraction, as these matters are judged by publishers, broadcasters, and journalists. Publishers and broadcasters are businessmen striving to maximize profits. Because most of their revenues come from the sale of advertising, and because advertising rates are largely determined by the size of the audience, audience appeal is crucial. Publishers and broadcasters will therefore employ and promote journalists who can deliver what the largest potential audience wants. Audience wants are largely determined by the considerations mentioned earlier: readers and viewers most want to know about events that seem likely to directly affect their interests, and they especially want to know about them if there appears to be an opportunity to take some action that will further or protect those interests.

Two qualifications are in order. First, the more complex an issue appears to be, the less is its appeal, other things being equal. This outcome expresses the principle of rational ignorance: the expected return on an investment in knowing must exceed the costs of knowing. Second, the more familiar is the frame of reference (including the ideological component) in which an issue is couched, the greater is its appeal, other things being

equal. In this case the conclusion follows from the cognitive dissonance principle: people do not like to have their beliefs challenged.

These considerations bear upon the public decision-making process in two important ways. First, by giving prominence to news items that, superficially at least, are readily understandable, concern events that affect the interests of many individuals, and are consistent with many individuals' prior beliefs (favourable or unfavourable prejudices), the mass media, particularly the newspapers, can largely determine the agenda for the public policy debate. Thus the attention given by the news media some years ago to NDP leader David Lewis' phrase "corporate welfare bums" made the question of tax concessions for business a prominent issue. Similarly, the media attention given to Stephen Lewis' attack on "rent gouging" did much to raise the issue of rent control.

Second, a government can reward uncommitted voters at the expense of committed voters at little risk to itself by ensuring that its announcements are absorbed by the winners but ignored by the losers. They can do this by

1. increasing the complexity of the method of intervention so that it will be reported only in specialized publications that are familiar to the winners but not to the losers;
2. emphasizing the direct benefits while downplaying the indirect costs;

3. concentrating the benefits but spreading the costs, with the result that the winners invest in knowing and organizing while it is not in the interest of the losers to become informed, much less organized to fight.

Let us now consider the imposition of rent control in Ontario with these points in mind.

As I said in the first section of this paper, outward appearances at least suggest that during the election campaign of 1975 the party in power in Ontario reluctantly and belatedly came to the view that some direct government intervention in the rental market for accommodation was inescapable, given the escalating promises of the two opposition parties. The Davis government was returned with a minority, and in order to retain power it had to make peace with the opposition parties by adopting a moderate form of rent control. The Davis Government may have regretted its delay in going this far since there seems to be some reason to think it would have won a clear majority if it had introduced controls before the election.

Be that as it may, it is probably valid to claim that, generally speaking, tenants were not organized as a pressure group prior to the imposition of rent control except incidentally as members of the NDP -- the party that had pressed for rent controls much earlier than the 1975 election campaign. If this was the situation, then the NDP and, at

the eleventh hour, the Liberals were initially the tenants' pressure groups.

Political parties, in their competition for the broadest coalitions of interest groups, may serve the important function of identifying latent groups that, when they are made aware of their shared concerns and see an opportunity to exploit their bargaining power, organize and take on a more or less independent existence. This certainly seems to be how tenants' associations came into being in Ontario.

Tenants' associations are now commonplace. For example, more than one hundred tenants' associations belong to the Federation of Metropolitan Toronto Tenants' Associations, which does not include all such associations in Metropolitan Toronto. Probably most tenants' associations were formed only when it became manifest to tenants that they had something to lose if they did not participate in the rent review process as it applied specifically to their own accommodation. When the enactment of rent control was uncertain and its implications for particular tenants were tenuous, the free-rider problem presumably discouraged the creation of pressure groups for the sole purpose of securing and maintaining the benefits of rent control for tenants generally. Furthermore, casual empiricism suggests that individuals are willing to fight more strongly to retain a benefit that they have obtained than they are to fight for one that they have not experienced. "A bird in the hand...." The opposition political parties, it should be recalled, faced little if any additional out-of-pocket

costs in taking up the pro-controls banner.

One might continue this line of speculation and suggest that landlords probably faced the same problems in organizing a campaign against rent control. Obviously there are fewer landlords than there are tenants, but the number of landlords is not small: out of approximately one million rental units, over 300,000 units are contained in buildings with less than six units (see COIRT 1984, Table 13). Moreover, the pressure for rent controls increased rapidly in the summer and fall of 1975 -- perhaps too rapidly for the creation and financing of an effective anti-controls lobby. A survey of media coverage of this issue in the months preceding the election would be instructive, but such an undertaking lies beyond the scope of this study.

For the tenants, once again, the introduction of rent control appears to have made it feasible to form associations for the purpose of battling rent increases in particular buildings. The stakes were now clear and free-riding could be controlled. It was then but a simple step conceptually, although no doubt a difficult one in practice, for the building associations to band together in federations that would lobby for the continuation and strengthening of controls. The Toronto federation estimates that between October 1982 and September 1983 about one-third of its resources of $72 thousand were devoted to lobbying (Robinson 1984). Thus the Conservatives' reluctant introduction of a moderate form of controls in response to a largely unorganized demand seems to have given rise to

organized tenants' groups -- and landlords' groups as well -- with permanent staffs and facilities.

The politics of rent control is perhaps no more complicated than it appears to be on the surface. There are many more tenants than there are landlords; in some urban constituencies there is high concentration of tenants; for many tenants rent payments are <u>the</u> major item of expenditure. Furthermore, a high proportion of the tenants in the urban core are probably highly mobile geographically, economically, and socially, and therefore uncommitted to any political party on a long-term basis. The competition among political parties for the support of tenant-voters in the high density urban ridings must therefore be intense.

Superficially, it would seem valid to assert that what the landlords lack in numbers they make up in financial resources. Could the landlords not better "afford" than the tenants to finance a vigorous lobby and gain political support through political contributions of one kind or another? No "answer" to this question will be attempted here for the simple reason that the relevant facts are unknown. Four considerations might suggest that the "obvious" is not as obvious on more careful consideration.

1. Landlord groups, actual or latent, suffer from free-rider problems too: landlords are numerous, vary greatly in size (number of units) and resources, are geographically dispersed, and conceivably do not have a common interest on <u>all</u> rent control matters.

2. Political contributions, in cash or kind, are potentially highly embarrassing if disclosed and might be construed as attempts to secure favourable consideration on matters other than rent control (zoning, for example).

3. The mass media probably handle the public relations materials supplied by the tenants' associations much more sympathetically than they handle similar materials provided by the landlord groups. Thus a dollar spent on publicity may go significantly further for the former than it goes for the latter. Perhaps this state of affairs is attributable in part to the self-interest of journalists, who, in all likelihood, are more commonly tenants than landlords (or home-owners). Editors, publishers, and broadcasters may give tenant-supporting items more prominence because a higher proportion of their audiences are thought to be "interested" -- which is to say not disinterested.

4. Conceivably, most of the friends and relatives of most home-owners are, or are likely to become, tenants rather than landlords. Consequently, home-owners as a group may identify more with the former than the latter, even though on the face of it one might expect them to be either neutral or sympathetic to landlords on the rent control issue.

RECONCILING OF THE CONVENTIONAL AND THE PUBLIC CHOICE APPROACHES

This study has put forth what would seem to be two quite inconsistent views of the world. The public choice approach

emphasizes the incentives under which the principal actors play their parts in each of the unique public-decision-making games. The conventional welfare economics approach, on the other hand, essentially assumes away the problems of public decision-making by postulating the existence of a benevolent, all-knowing dictator whose decisions about the relative importance of the interests of different individuals are embodied in a hypothetical Social Welfare Function. Given this specification of social objectives and the weight to be attached to the interests (utility) of each individual, it is but an exercise in mathematics to specify the marginal conditions that must be met in order to achieve economic efficiency (Pareto optimality). The crucial task is to identify the links, if there are any, between these two conceptual schemes -- one of which focuses upon the resolution of individual and group conflict through the political process while the other neatly side-steps the existence of such conflict by postulating an absolute authority.

Becker (1983) has made an attempt to reconcile the two approaches. His model has two sectors: one consists of organized groups of taxpayers and the other consists of organized groups of subsidy recipients. (In Becker's formulation, regulatory and other policies that have the same <u>effects</u> as taxes and subsidies are treated as taxes and subsidies.) In the present context, landlords who own residential properties subject to rent control are the organized tax-paying group. The tenants are the subsidized group.

The tax revenues must finance the subsidy disbursements. But the tax costs are the sum of tax revenues plus the deadweight (inefficiency) costs resulting from the allocation-distorting effects of attempts to avoid them, while the subsidy benefits are the sum of actual disbursements less the deadweight costs resulting from the allocation-distorting effects of attempts to secure them. Thus, when the deadweight costs are considered, the tax costs are greater than the subsidy benefits they finance. Other things being equal, the taxpayers have a greater incentive to fight against the cost than the subsidy recipients have to fight for the (smaller) benefit.

While the levels of taxes and subsidies are not equal, they are, of course interdependent, since the one must "finance" the other. In Becker's formulation, their actual levels depend upon the relative success of each of the two organized interest groups in acquiring political influence. A crucial assumption in Becker's analysis is that the sum of the political influence of groups must be zero -- influence is a zero-sum game. This means that an increase in the influence of the taxpaying group necessarily entails a corresponding reduction in the influence of the subsidy-receiving group. Presumably, influence is related to, among other things, organizational efficiency and the ability of groups to finance their lobbying efforts. With perfect organizational efficiency, free-riders would be precluded at zero cost and those affected would be willing to finance

lobbying up to the risk-discounted expected value of the full cost (in the case of taxpayers) or the net benefit (in the case of subsidy receivers).

Becker emphasizes not only that political influence is a zero-sum game but also that it is the relative effectiveness of the contending interests in exerting influence that is the relevant consideration, not their absolute effectiveness.

The behavioural adjustments of reluctant taxpayers and aspiring subsidy recipients result in a negative-sum game -- the negative difference between the gains and losses is equal to the deadweight utility losses incurred by both sides. Because "deadweight losses" are synonymous with inefficiency costs, and because the minimization of inefficiency costs is the essence of welfare economics, there can be no doubt that Becker's formulation incorporates the latter. It does so, moreover, in a manner that emphasizes political activities -- particularly lobbying -- as the means of maximizing net gains or minimizing net losses from government intervention.

Another important assumption in Becker's formulation is that as taxes per capita rise their (marginal) deadweight costs per capita also rise, and rise more than proportionally, thereby adding to the burden. This outcome stimulates increased pressure on government from taxpayers. Conversely, as subsidies rise their deadweight costs also rise, and rise more than proportionally, reducing the net benefit. This outcome dampens political pressure from the

subsidized. The result is a stable solution, for not only do taxpayer groups have an inherent advantage over subsidized groups but this advantage increases as taxes and subsidies increase. This conclusion suggests that if for some reason, such as a change in organizational efficiency, the influence of the subsidized group increased and the influence of the taxed group necessarily decreased, the latter group would be induced to spend proportionately more to apply counter-pressure, because otherwise its burden would increase by more than the increase in the benefit it financed.

At the heart of the Becker model is the concept of equilibrating pressure. Individual members of groups will contribute to the "pressure funds" of the groups up to the point at which the additional pressure thus purchased just yields an equal additional advantage through lower taxes or greater subsidies. The size of the additional benefit depends upon the expenditures of the opposing group and their efficiency in generating influence. The Becker model incorporates a notion of optimal group size -- a size that captures most of the benefits of declining fixed costs yet is not swamped by the rising costs of deterring free riders. However, Becker says little about what determines the efficiency of groups in "buying" influence. He treats unorganized voters, to the limited extent that he considers them, as uninformed ciphers whose votes can be purchased through advertising by the organized interest groups.

Although Becker does not consider it explicitly, his analysis leads him to a result that seems, superficially, to be contrary to Ontario's experience under rent control. His Proposition 3 states that "politically successful groups tend to be small relative to the size of the groups taxed to pay their subsidies" (Becker 1983, 385). The argument is that the more widely a given revenue is raised the smaller is the deadweight cost per taxpayer (and in total). This reduces taxpayer pressure. On the other hand, the larger is the number of persons subsidized from a given sum, the smaller is the benefit per member and the smaller is the deadweight cost per member. If other things remain unchanged, this result increases the pressure for subsidies. Therefore the optimal size of the subsidized group is likely to be smaller than that of the taxed group unless, for some reason, the organizational and lobbying efficiency of the recipient group is greater than that of the taxed group.

Without the qualification, this proposition is clearly at odds with the nature of residential rent control, under which the taxed group, the landlords, is much smaller than the subsidized group, the tenants. The explanation of this seeming anomaly is presumably that tenants' groups possess organizational advantages that minimize the costs of controlling free-riders as group size increases. This explanation is not implausible, given that members of tenants' groups are readily able to identify and to apply social and other pressure to free-riders living in the same building.

Becker makes three additional points that are germane

to the subject of rent control:

1. It is a well-established proposition in economics that demand and supply become more price sensitive (elastic) with the passage of time. In the case of demand, price sensitivity increases because with the passage of time behaviour can adapt more fully to changes in the relative prices of substitutes; in the case of supply, it increases because over time existing firms can add physical capital and equipment through investment or subtract them through depreciation. Firms can also enter or leave the industry. However, greater elasticity of demand or supply means greater distortion, with its attendant deadweight (inefficiency) costs. Moreover, the number of taxpayers and the average tax paid tend to fall and the number of qualified subsidy recipients tends to increase, with an attendant fall in the average subsidy. These changes raise the burden on individual taxpayers and lower the benefit for individual subsidy recipients. Becker believes that waves of enthusiasm for deregulation simply reflect the increase in deadweight costs over time (ibid., 383).

In a market for residential accommodation with both a controlled and an uncontrolled sector, as in Ontario, one would expect that, with the passage of time for full adjustment, the supply of controlled accommodation would become perfectly elastic through conversions and through quality reduction brought about by reduced maintenance that

kept pace with the reduction in real rents. Landlords would ultimately receive the same required after-tax rate of return as they would receive on other investments of comparable risk. They would be indifferent to rent control except as a potential threat -- it could be extended to previously uncontrolled units. If, as Rosen and Smith (1983) claim, the rents (actual or imputed) on uncontrolled apartment units and on owner-occupied housing are raised by controls on other units, some landlords and all individuals who occupy their own accommodation might in fact be reluctant to see controls removed.

If, on the other hand, real rents decline faster than quality declines through reduced maintenance, controls reduce the market value of the building. In these circumstances, the removal of controls would create a capital gain for landlords. In the longest of runs, however, all of the controlled building stock is torn down and only the uncontrolled stock remains -- assuming, of course, that controls are not extended to new construction.

The demand for rent-controlled units is also likely to become more elastic with the passage of time as a result of the increased availability of substitutes (owner-occupied and uncontrolled units). The more elastic is the demand, the greater is the deadweight loss that results from controls. The result would be a reduced enthusiasm for rent control on the part of the tenants of controlled units.

2. Although Becker does not consider voting behaviour,

except to observe that the organized can buy the electoral support of the unorganized through "advertising", he argues that governments will adopt the most efficient taxes and subsidies. This result is explained by the competition among political parties. If a party were to introduce taxes or subsidies with supraminimal deadweight losses, a competing party would presumably promise more efficient taxes and subsidies and win the next election. This argument implies that residential rent controls are more efficient than, say, housing allowance subsidies to those with low incomes financed, say, by an increase in real property taxes, since controls offer fewer opportunities for tenants and landlords to adjust their behaviour in order to maximize benefits and minimize costs. However, if point (1) is valid, what was the most efficient tax or subsidy at the time of imposition is unlikely to still be the most efficient after enough time has elapsed to permit behavioural adjustments.

This does not mean that had the less efficient alternative been chosen at the outset it would now be more efficient than is the alternative that was in fact chosen. Rather, it means that the initially more efficient alternative may now be less efficient than the rejected alternative would be if it were adopted now. Presumably any policy should be replaced after a few years, restored a few years later, and then replaced again -- and so on ad infinitum.

The notion that the competition among parties results

in the choice of the most economically efficient of policy instruments would seem to presuppose a strange political system -- that is, one in which each election is fought about only one policy issue. In point of fact, parties are bundles of "characteristics", and rent control and its substitutes constitute but one of a multitude of issues.

3. Groups that press for efficiency-raising taxes or subsidies (to offset market failures) have an intrinsic advantage because their solutions, when successful, reduce deadweight losses. Their efforts are likely to meet with political success because, other things being equal, they will have relatively little opposition. Those who are taxed will face costs that are less than the revenues would suggest because the taxes are offset by efficiency gains. Similarly, when subsidies are market-correcting, they are enhanced by efficiency gains rather than partly offset by efficiency losses.

An argument can be made that the sharp increase in residential rents in Ontario in 1975 was a short-run phenomenon. The imperfect expectations of suppliers meant that there was an inadequate increase in supply to meet increased demand. The passage of time would have rectified the "shortage", but the social and economic (transaction) costs of adjusting to a temporary price phenomenon can be considered wasteful. Because demand and supply were inelastic in the short-run, the short-run deadweight costs of controls were small. Moreover, these costs were

conceivably more than offset by the efficiency gains -- that is, by the absence of the transaction costs associated with physical movements from accommodation to accommodation in response to temporary rent changes.

In time, however, the market imperfection rationale for controls ceased to hold. Deadweight costs increased for both landlords and tenants and a tax-subsidy scheme that began as a least-cost measure was no longer the most advantageous alternative.

Hettich and Winer (1984) developed a model that is in the same spirit as Becker's work but more sophisticated in several respects. In particular, they correctly place the vote-maximizing objective of contending political parties at the core of their model. In Becker's formulation, the result is determined by contending lobbying groups and the political process is completely implicit. Hettich and Winer assign a positive role to the unorganized, while in Becker they are entirely passive. Becker is concerned only with the economic costs of political behaviour as reflected in "voice" (lobby). Hettich and Winer consider both "voice" and "exit", which means a reduction in taxes through shifting to activities that yield untaxed returns. "Exit" implies deadweight losses.

Tax and subsidy structures are undefined in Becker. Hettich and Winer fully define the tax aspect of these structures and could presumably extend this effort to the subsidy aspect as well. They agree, however, that dead-

weight costs affect political behaviour and that competition among politicians results in the choice of the most efficient policy instruments.

The basic fixtures of the Hettich-Winer model are of some interest in the present context. Again, it is assumed that political parties compete for votes. In order to compete, political parties need resources for organization purposes and for advertising the party's merits to the unorganized voters. These resources are obtained as "bribes" from the informed, organized sector (which through government regulation is able to control entry) in exchange for tax concessions for itself. The uninformed, unorganized sector is persuaded by "political" party advertising of the net benefits that the party will provide if elected.

For both the organized and unorganized sectors, higher taxes result in lost votes. However, these vote losses are reduced when exit (untaxed activities) opportunities are available. Such opportunities reduce the willingness of the organized group to "buy" tax concessions -- a factor crucial to politicians because the vote loss *per se* from the organized is immaterial, given the small size of the organized sector relative to the unorganized sector. Hettich and Winer then consider how a political party might modify the tax structure, taking into account the implications of exit noted above, so as to secure the requisite financing while imposing the minimum total deadweight costs (the sum of the deadweight costs of individual taxpayers). The relevant point is that in this formulation politicians

seek the most efficient tax structure, as most economists would expect them to do, but within the constraint posed by the need for party finance, as public choice theory suggests they would.

The most useful insight from Becker and from Hettich and Winer, for the purposes of this paper, is that political activity is not solely a function of the tax revenue and subsidized expenditures, but also a function of the deadweight (inefficiency) costs associated with each of them. Deadweight costs add to the tax burden and subtract from the subsidy benefit. What these economists appear to have in mind in considering deadweight costs are the utility losses arising from the resulting behavioural adjustments.

Becker explicitly takes into account the lobbying costs of organizations as an addition to the burden of taxpayers and as a subtraction from the benefits of subsidy recipients. Hettich and Winer, on the other hand, seem to treat them as part of the tribute that the organized pay to politicians in exchange for tax concessions. Neither paper acknowledges the transaction costs incurred by individual taxpayers and subsidy recipients in their struggles to minimize the former and maximize the latter net of these costs. It will be recalled that it is an inference of rent-seeking theory that in a perfectly competitive situation (e.g., the hypothetical fishery) the struggle for subsidy benefits will entirely dissipate their value because they are non-exclusive rights. Dissipation is prevented only when the number of parties seeking the benefits is sufficiently small

to permit contractual arrangements. As Dales puts it in commenting on Cheung's analysis of non-competitive struggles for benefits:

> In these situations not all rents will be dissipated because the people involved will try to contract with one another in order to prevent the total loss of the unassigned income; the general supposition then becomes that rent will be completely dissipated only in the area where the marginal cost of contracting exceeds the marginal reduction in waste. (Dales 1983, 260)

Perhaps the simplest and most blatant form of contractual arrangement in the field of residential rent control is the illegal payment by prospective tenants of "key money" that is approximately equal to the present value of the difference between the controlled and the uncontrolled rent. "Key money" may be demanded either by landlords or by tenants who are offering a sub-lease. A more sophisticated contractual arrangement is the conversion of a rental contract into a condominium sales contract. This conversion by contract prevents the dissipation of the "unassigned income", which in present value terms is then, in effect, exclusively assigned to either the vendor or the buyer or is divided between them.

SOME GENERAL IMPLICATIONS

The term "rent seeking" is unfortunate in at least two respects: it is readily confused with the extremely

different concept of economic rent;[9] it is also readily confused with the conventional meaning of rent -- the periodic payment for the use of a thing, such as residential accommodation. However, the term "rent seeking" is now so firmly embedded in the economics literature that it is probably too late to call the phenomenon to which it relates something like "investing in influencing government decisions" -- which is more descriptive and less emotive.

Putting aside the terminology, is the concept helpful to the analysis of residential rent control in Ontario? The theory of rent seeking does seem to provide several significant insights that do not emerge from traditional economic or practical analysis.

Rent control can be thought of as a system of simultaneous taxes or transfers under which tenants are empowered by law, as applied by the regulatory agency, to "tax" landlords and keep the proceeds -- the rent saving. The effects of taxes and transfers have traditionally been analyzed primarily in terms of their income and substitution effects. They change the incomes (in cash or kind) of those taxed and subsidized and, therefore, their consumption/saving and investment decisions. They also change relative prices, bringing about the substitution of that which has become relatively cheaper for that which has become relatively dearer. In a world of perfect markets (<u>even without transaction costs</u>), the result is a misallocation of resources in the sense that individual decisions

are distorted. While the distribution of income and wealth may be improved -- a necessarily subjective determination -- there is an economic efficiency loss (cost). Only if the redistribution could take place under highly improbable circumstances -- an unanticipated, once-and-for-all, instantaneous, simultaneous confiscation and gifting -- could these costs be avoided. Because the "benefits" (if such they be) of the redistribution are incommensurate with the efficiency costs, no calculation of net benefit (or cost) is possible.

The recognition that individuals and groups make investments in securing the transfer or resisting the tax -- the gist of the theory of rent seeking -- alters the picture considerably. With competition, and given a reasonably well-informed populace with a means of circumscribing free-riding at a reasonable cost, the contending parties will invest in securing favourable (to them!) government rules and regulatory decisions. While the results are uncertain, the overall expected return (benefits obtained or costs avoided) will be normal. There will be no supranormal "profits" (i.e., economic rent). The attempted redistribution of income or wealth is therefore resource-using, as in conventional business investment, but it is not output-producing. In the extreme case, the investment of resources in securing favourable decisions is equal to or greater than the transfer. It has the same economic effect as a firework display produced for the blind and deaf -- a complete waste or "dissipation" of resources. Under some circumstances,

the value of the resources invested in obtaining the rents will just equal the value of the rents.

In point of fact, of course, competition is not perfect, nor is public information always reliable or unbiased. Some groups face higher free-rider and organizational costs than others. The actual degree of dissipation is therefore problematic. Nevertheless, there seems little doubt that conventional economics has hitherto neglected an important economic cost of measures such as residential rent control.

The foregoing argument was based on the assumption of perfect markets. Should markets be imperfect, significant qualifications must be introduced. Suppose, for example, that the residential rental market is imperfect in that it is subject to major cycles, which arise primarily from investors' failures to adequately forecast tenant demand. These failures bring about a lagged excess of construction that generates high vacancy rates (and low rents), which are followed presently by low vacancy rates (and high rents). This cycle is repeated again and again. One possible consequence is an economically costly high rate of tenant moves, since tenants will first try to upgrade and then be forced to downgrade their accommodation. Suppose that rent control tends, to some degree at least, to correct for this market imperfection. Would governments, as practical entities seeking the electoral support of tenants, institute this market-improving policy change without pressure from

tenants?

Public choice theory suggests that the answer is no. Under this formulation, it is only the competition among the parties for votes that provides the incentive for policy improvements.

It would take a great deal of faith to adhere to the proposition that interparty competition inexorably and invariably brings about ever more efficient policies. As I mentioned earlier, this view seems to assume that elections are issue referenda, that voters are fully informed, and that majorities (coalitions of minorities) do not attempt to coerce minorities without regard to the economic costs to society as a whole if their investments in government influence bring at least a normal return.

Consider the array of price controls in Ontario: agricultural price supports, minimum wage laws, fixed taxi fare rates, and a host of others -- all in addition to residential rent control. Is it not likely that the interest groups involved in securing these controls used the "market imperfections correction" argument as a plausible rationale for the adoption of policies that they thought would be in their interest (net of the transaction costs involved in obtaining the government rule changes and in securing favourable decisions under those rules)? After all, for an interest group to blatantly put its votes up for sale to the highest bidder without providing any apparent solace to the losers by way of justification is simply not done in "civilized" democracies.

The explanation for the existence and persistence of such policies as residential rent control in Ontario probably lies in certain fundamental aspects of voter perception, as affected by the biases of the news media and the prevailing political processes and institutions. Politicians, with rare exceptions, have to take the system as given. In some crucial constituencies, there are many tenants and few landlords; the tenants are widely accepted by others as deserving and the landlords are not. Free-riding is more cheaply minimized by building tenants' associations once they are established than it is by landlords; the lobbying contributions of landlords are therefore less than protection of their aggregate net worth would "warrant" -- a problem that may be intensified by rules restricting contributions to political parties. Prospective tenants of controlled accommodation -- one of the group of losers -- are not organized. The economic costs to society of price controls, including the transaction costs of rent seeking, are probably grossly underestimated by most "disinterested" voters who are in any event unorganized. And one could go on listing fundamental factors that "explain" the rent control phenomenon. The elimination of these imperfections in political markets, if such they may be called, will almost certainly be extremely difficult. Fortunately, the task is beyond the scope of this paper.

NOTES

1. See statements by Housing Ministers Sydney B. Handleman (June 11, 1974) and Donald R. Irving (December 5, 1974, April 22, 1975, June 5, 1975, July 30, 1975, and August 30, 1975) as reported in COIRT (1983).

2. See, for example, Arnott (1981) and Smith and Tomlinson (1981). The empirical analysis provided by Smith and Tomlinson is open to serious question. The direction of the changes is less controversial, since it can be largely deduced from the generally accepted assumptions of economics.

3. For a general description of welfare economics, see Henderson and Quandt (1958) and Hartle (1979, 145-72).

4. See Hayek (1975) and Friedman and Stigler (1975) for earlier criticisms.

5. For a survey of the critical commentary on the theory of rent seeking, see Hartle (1983) and the references cited therein.

6. Opportunity cost, probably the most important concept in economic theory, is the price that an input would command in its next-best use. Alternatively, it is the goods or services necessarily forgone because resources

with alternative uses are required for the production of a given output. Television stars usually command a high income. Were they precluded from a television career and obliged to sell their next-best attributes or skills, perhaps as secretaries or shoe salesmen, their incomes would be much reduced. The difference between the star income and the ordinary income is price rent. If this rent were taxed heavily, there would be no change in behaviour -- that is, no change in supply. The concept of economic rent also embraces what are called quasi-rents. Quasi-rents arise when, for example, there is a sudden, unanticipated increase in demand for a reproducible good or service. In the short-run, the supply is fixed and prices rise to ration the available quantity. Suppliers obtain a price that more than covers variable costs and a normal rate of return on investment -- that is, they obtain a quasi-rent. Quasi-rents, unlike price rents, are eliminated over time: existing suppliers increase output and new suppliers enter the industry, causing prices to fall until they just cover costs (defined to include a normal return).

7. Presumably the word "rent" in the term "rent seeking" was adopted because, like economic rent, the return from efforts to affect government decisions is unrelated to additional physical production. But this

is as far as the similarity between the two types of rent goes.

8. See Mueller (1979) for an encyclopedic survey of the theory of public choice. An approach similar to that taken in the present paper can be found in Hartle (1979).

9. See note 6.

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